Before the
Federal Communications Commission
Washington, D.C. 20554

In the Matter of	
Connect American Fund	WC Docket No. 10-90
A National Broadband Plan for our Future	GN Docket No. 09-51
Establishing Just and Reasonable Rates for Local Exchange Carriers	WC Docket No. 07-135
Federal -State Joint Board on Universal Service High-Cost Universal Service Support	WC Docket No. 05-337
Developing an Unified Intercarrier Compensation Regime	CC Docket No. 01-92

EX PARTE COMMENTS

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May 25, 2011

I. Introduction

My name is Harold Furchtgott-Roth. In November 2010, I prepared a report in Docket 07-135 that addressed issues related to inter-carrier compensation.[1] I have reviewed many of the submissions in both the initial round and the reply round of comments in the current Notice of Proposed Rulemaking (NPRM).[2] Nothing in the record that I have reviewed would cause me to alter the findings or opinions presented in my November 2010 paper. I request that my initial report be added to the record in the current proceeding.

Throughout my career, I have taken a skeptical view of regulation that either:

- goes beyond statutory requirements and lacks a clear legal basis;
- regulates prices;
- resembles industrial policy; or
- fails to demonstrate that benefits exceed costs.

Regrettably, the proposed rules with respect to access stimulation meet not one but all of these criteria for skepticism.

In addition to the findings in my initial report, based on the current NPRM I have the following findings:

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1 FCC, Docket 07-135, Comments of H. Furchtgott-Roth, November 30, 2010. That report can be found at http://fjallfoss.fcc.gov/ecfs/document/view?id=7020921723.

2 *See Connect America Fund*, WC Docket No. 10-90, *A National Broadband Plan for Our Future*, GN Docket No. 09-51, *Establishing Just and Reasonable Rates for Local Exchange Carriers*, WC Docket No. 07-135, *High-Cost Universal Service Support*, WC Docket No. 05-337, *Developing an Unified Intercarrier Compensation Regime*, CC Docket No. 01-92), *Federal-State Joint Board on Universal Service*, CC Docket No. 96-45), *Lifeline and Link-Up*, WC Docket No. 03-109, Notice of Proposed Rulemaking and Further Notice of Proposed Rulemaking, FCC 11-13, released February 9, 2011.

- The NPRM still fails to articulate a compelling need for new rules much less a statutory necessity or even statutory preference for the specific proposed new rules;
- The NPRM misuses the word "arbitrage";
- Rather than a rule based on statutory necessity or reflective of expanding competition, the NPRM proposes a rule based on an assessment of profits under current market conditions, ultimately favoring one group of firms over another;
- Even if writing rules based on an assessment of profits under current market conditions were appropriate, the NPRM presents no new verifiable information upon which to base those rules;
- The NPRM proposes a dangerous precedent of regulating revenue sharing;
- The NPRM proposes to expand rather than contract price regulation despite the presence of more rather than less competition;
- The NPRM fails to recommend deregulation when deregulation is both the obvious and lawful solution; and
- The NPRM fails to comply with the Regulatory Flexibility Act.

I review each of these topics in turn. I gratefully acknowledge some financial support in preparing these comments to Northern Valley Communications, but the views expressed below are my own.

II. The NPRM still fails to articulate a compelling need for new rules much less a statutory necessity or even statutory preference for the specific proposed new rules

As I discussed in November 2010, the original NPRM in Docket 07-135 failed to explain any compelling need for new rules. [3] In particular, it lacked a clear purpose with well-defined

[3] See fn. 1 *supra*, at Section IV.

concepts, lacked a clear distinction between lawful and unlawful activities, failed to explain how the proposed rules would accommodate current market conditions, failed to explain why current rules are inadequate for the issues posed, lacked a clear explanation of how the proposed rules were consistent with existing law and Commission decisions, and failed to explain the harms without new rules.[4] The current NPRM does not correct these deficiencies.

The current NPRM discusses as well as presents the proposed new rules for access stimulation.[5] The NPRM's discussion of rules for access stimulation provides discussions of the parameters and *limitations* on how access stimulation rules might be constructed, but not on the *necessity* of writing new rules. The NPRM refers to several sections of the Communications Act, but in practically each instance, the NPRM addresses more the limitations on the structure of the proposed new rule. For example, the NPRM addresses each of the following sections of the Communications Act in the following contexts:

- 201 – interpretation of 201 under the deemed lawful status of filed rates,[6] current refusal of Commission to determine that all forms of revenue sharing violate Section 201 *per se*,[7] request for comment on whether all forms of revenue sharing violate Section 201 *per se*,[8] relationship between Sections 201 and 251(b)(5) for dial-up ISP traffic,[9] and request for comment on permissibility under Section 201 of Commission rules on access stimulation triggers;[10]

4 *Ibid*.
5 *See* NPRM. For the discussion of the proposed new, *see* NPRM particularly at paragraphs 36, 606, and 635-677. For the presentation of the proposed new rules, *see* NPRM at Appendix C.
6 *Ibid*.
7 *See* NPRM, paragraph 661.
8 *See* NPRM, paragraph 670.
9 *See* NPRM, paragraph 671.
10 *See* NPRM, paragraph 674.

- 201(b) – interpretation that bundling revenue sharing "costs with access is engaging in an unreasonable practice that violates section 201(b)";[11]
- 203(c) – complaint process for IXCs asserting that access charges are too high,[12] and request for comment under 203(c) of ban on off-tariff rebates;[13]
- 204(a)(3) – deemed lawful status;[14]
- 251(b)(5) – reciprocal compensation,[15] and the Commission's request for comments on the lawfulness of applying bill-and-keep to reciprocal compensation;[16]
- 254(g) – prohibition on interexchange carriers charging customers different rates in different states (and, as I discuss below, presented inaccurately in the NPRM);[17]
- 254(k) – prohibition on cross-subsidization;[18]
- 332 -- request for comment on permissibility under Section 332 of Commission rules on access stimulation triggers;[19]
- 503 – paired with request for comments on 203 (c) on the ban and penalties for off-tariff rebates;[20]

None of the sections of the Communications Act presented in the NPRM begins to explain any *preference* for new rules much less a *necessity* of new rules. Some of these are the same issues

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11 *See* NPRM, paragraph 661.
12 *See* NPRM, Footnote 1015.
13 *See* NPRM, paragraph 677.
14 *See* NPRM, at paragraphs 653 and 666. Discussion of possible exceptions to deemed lawful status of filed tariffs.
15 *See* NPRM, footnote 982. Discussion of wireless traffic within the same major trading area (MTA). *See* also footnote 1054.
16 *See* NPRM, paragraph 674.
17 *See* NPRM, at paragraph 654.
18 *See* NPRM, paragraphs 659 and 676.
19 *See* NPRM, paragraph 674.
20 *See* NPRM, paragraph 677.

that the Commission raised in the 07-135 NPRM, and none of those issues compelled new rules.[21]

III. The NPRM misuses the word "arbitrage"

Rather than a rule based on statute, the NPRM presents market conditions which it claims need to be addressed.[22] At the core of the market conditions that the Commission claims need to be addressed is what is disparagingly and repeatedly refers to as "arbitrage." The word appears 60 times in the NPRM, and many of those instances are with respect to access stimulation. This is a substantial departure from the 2007 NPRM in 07-135 where the word "arbitrage" appeared but once.[23]

It may come as a surprise to many economists that the Commission takes a dim view of "arbitrage," even demonizing the word. It may also come as a surprise to the Commission that economists generally have a positive view of arbitrage. To an economist, arbitrage is supportive of market efficiency. Economists sometimes speak of the transactions costs or "arbitrage costs" as enabling price discrimination, often to the detriment of consumers.[24] Where arbitrage is pervasive, markets are more likely to be efficient.

Arbitrage is simply the taking of an asset or service from one market where it can be obtained at one price and simultaneously and risklessly selling it in a different market where it can fetch a higher price. According to *The American Heritage Dictionary,* arbitrage is "the purchase of securities on one market for immediate resale on another in order to profit from a

[21] *See* fn 1, *supra*, Section VI.
[22] *See* NPRM, paragraphs 635-638.
[23] FCC, *Establishing Just and Reasonable Rates for Local Exchange Carriers*, Docket 07-135, Notice of Proposed Rulemaking, October 2, 2007.
[24] *See* e.g., J. Tirole, *The Theory of Industrial Organization*, 1989, The MIT Press, Cambridge, MA, at 134-135.

price discrepancy."[25] If gold sells for $1500 an ounce in London and $1600 an ounce in New York, other factors equal, traders will buy gold in London and simultaneously sell it in New York until the markets equilibrate. Buying low and selling high is a practice as old as markets. This arbitrage is not a sinister activity but the means by which efficient markets equilibrate. In much of the economics and financial literature and common parlance, arbitrage is a good practice, not a bad one, and certainly not one that government ought to prohibit much less regulate.

Thousands of Americans earn their livelihood lawfully and respectably engaging in arbitrage. Practically every American benefits from arbitrage across markets; without it, our markets would be far less efficient and we would all be the poorer.

What exactly does the Commission mean by arbitrage in the context of access stimulation? Surely it is not the purchase of exchange access services at one price and selling them at another. I am not aware of such instances described in this proceeding. Nor am I aware of instances of the purchase of long-distance services at one price and the selling of them in a different market at a different price. Moreover, while exchange access services are subject tariffs and formulas and implicit price regulation, none of the proposed rules of the Commission is the usual solution to problems price regulation—deregulate the prices. Long distance services offered by IXCs already are not price regulated. It is difficult to see how the situation described by the NPRM could possibly be a form of arbitrage, and the NPRM does not explain itself.

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[25] *The American Heritage Dictionary*, Second College Edition, 1982, Houghton Mifflin Company, Boston, at 124.

IV. Rather than a rule based on statutory necessity or reflective of expanding competition, the NPRM proposes a rule based on an assessment of profits under current market conditions, ultimately favoring one group of firms over another

Rather than rely on statutory necessity for a rule, the NPRM focuses on a supposed market need for a rule, often suggesting that "arbitrage" will take place otherwise. The discussion makes little economic sense. Consider paragraph 636:

> 636. In broad terms, access stimulation is an arbitrage scheme employed to take advantage of intercarrier compensation rates by generating elevated traffic volumes to maximize revenues. Access stimulation occurs when, for example, a LEC enters into an arrangement with a provider of high call volume operations such as chat lines, adult entertainment calls, and "free" conference calls. The arrangement inflates or stimulates the amount of access minutes terminated to the LEC, and the LEC then shares a portion of the increased access revenues resulting from the increased demand with the "free" service provider. Although the conferencing or adult chat lines may appear as "free" to a consumer of these services, the significant costs of these arbitrage arrangements are in fact borne by the entire system as long distance carriers that are required to pay these access charges must recover these funds from their customers.[26]

Paragraph 636 makes little economic sense for at least the following reasons:

- Firms do not usually maximize "revenues" but rather profits. The NPRM does not address why it focuses on revenues rather than profits.
- Expanded output or "elevated traffic" usually benefits sellers of services, particularly ones that are not price regulated. The NPRM does not explain why "elevated traffic" is not beneficial. Indeed, in many other areas, such as wireless traffic and broadband traffic, the Commission properly trumpets elevated traffic.
- The paragraph focuses on the sharing of revenue with the "'free' service provider. If the revenue were not shared, would the Commission's view be different? How does a firm's use of revenue affect a regulator's view of a regulated transaction?
- Yes, "long distance carriers that are required to pay these access charges must recover these funds from their customers," but the same statement could be made about services

[26] NPRM at paragraph 636, footnotes omitted.

offered in any market. The mere statement that firms must recover costs does not mean the payment of charges is economically inefficient or that the charges are not assessed to the parties that incur them. The same statement could be said for special access charges which may or may not be assessed to the parties who incur the costs.

In paragraph 637, the Commission does little better:

> 637. Access stimulation imposes undue costs on consumers, inefficiently diverting the flow of capital away from more productive uses such as broadband deployment, and harms competition. Although long distance carriers are billed for and pay for minutes associated with access stimulation schemes, all customers of these long distance providers bear these costs and, in essence, ultimately support businesses designed to take advantage of today's above-cost intercarrier compensation system. Projections indicate that the annual impact to the industry from access stimulators is significant. TEOCO estimates that the total cost of access stimulation to the industry has been over $2.3 billion over the past five years. Verizon estimates the industry impact to be between $330 and $440 million per year and as noted above, states that it will be billed between $66 and $88 million by access stimulators for approximately two billion wireline and wireless long distance minutes in 2010. Although these projections are subject to debate in this proceeding, and there may be litigation surrounding payment of some of these charges, the record also suggests that the amount of capital that access stimulation diverts from broadband deployment and other investments that would benefit consumers is substantial.[27]

Paragraph 637 also makes little economic sense for at least the following reasons:

- The first sentence about "diverting the flow of capital" is unsubstantiated and makes little sense.
- The second sentence is factually incorrect. Not all long distance carriers "pay" for minutes associated with "access stimulation schemes."
- Moreover, carriers that assess customers on a per-minute basis or that assign the costs of access charges to their customers do not assign the costs to "all customers."
- Even if it were true that "all customers" bear the costs of access charges, it does not necessarily follow that the outcome is inefficient. The same situation holds for special

[27] NPRM at paragraph 637, footnotes omitted.

access charges for broadband providers that charge customers on a flat fee basis, but it does not follow that broadband customers are harmed by special access charges.

- The TEOCO study measures neither the actual payments made by, or profits of, long distance companies.[28]

In the context of “access stimulation,” it appears that the Commission means a practice that is not arbitrage at all. Rather, than define how “access stimulation” is inconsistent with the Communications Act, the NPRM, particularly in paragraph 637, focuses on the supposed “cost” to the long distance industry, even though the industry appears to be profitable.[29] In the NPRM, the issue is less about how a practice violates the law than it is about how a practice results in certain market outcomes. The Commission should write rules based on statutory requirements, not based on its assessment of profits at a point in time.

To see the incongruity of framing regulations based on market outcomes rather than the necessity of law, suppose the market outcome is unknown to the Commission. One might describe two situations which the Commission can distinguish based on the current record:

A: (Wholesale price of exchange access paid by carrier)

+ (other carrier costs including markup) < (incremental revenue of call)

and

B: (Wholesale price of exchange access paid by carrier)

+ (other carrier costs including markup) > (incremental revenue of call).

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[28] Available at: http://whitepapers.ccmi.com/WhitepaperSummary.aspx?whitepaper_id=116.

[29] Although each of the major long distance companies report profitable long distance businesses in their Forms 10K, it is hypothetically possible to be profitable and yet be less profitable than otherwise.

Under situation A, the carrier has the cost of a call that is less than its retail rate, and the carrier benefits from each such call. Under situation B, the carrier has costs that are greater than the incremental revenue from the call, and carrier loses money on each such call.

Whether a long-distance carrier is in situation A or B has nothing to do with the usual definitions of arbitrage, or for that matter whether exchange access practices are consistent or inconsistent with the Communications Act. Situations A and B may occur where LECs comply with the Act or where they do not comply with the Act. In many instances, whether a long-distance carrier faces situation A or B is overwhelmed by the other incremental costs of service. Equally troubling, a long-distance carrier may switch from situation A to B, and back, independent of access charges or access stimulation. The Commission in the NPRM does not articulate how to distinguish whether a long-distance carrier is in situation A or B, and exactly how that situation affects the Commission's decision to consider new rules for access stimulation. The Communications Act provides the Commission with no clear statutory authority to regulate IXC and LECs in one way under situation A and a different way under situation B.

V. Even if writing rules based on an assessment of profits under current market conditions were appropriate, the NPRM presents no new verifiable information upon which to base those rules

Even if it were proper for the Commission to write rules based on the relative profitability of firms, the current NPRM presents no verifiable information upon which to write those rules. The NPRM cites a couple of outside sources on expenses, but not profits. At least one of those studies is not verifiable.[30] The net result is that if the Commission wished to write rules based on the changing profitability of certain activities of certain companies, it has not collected or at least not disseminated that profitability information to the public.

30 Available at: http://whitepapers.ccmi.com/WhitepaperSummary.aspx?whitepaper_id=116.

VI. The NPRM proposes a dangerous precedent of regulating revenue sharing

Regulating revenue sharing, as proposed in the NPRM, would be a dangerous precedent for the Commission. Revenue sharing is a common and commercially competitive practice in many industries including the wireless industry and the broadband services industry. I am not aware that the Commission has regulated revenue sharing in the past, and such regulation would discourage development of business models based on revenue sharing.

VII. The NPRM proposes to expand rather than contract price regulation despite the presence of more rather than less competition

The Communications Act does not compel the Commission to regulate any price, and Sections 10 and 11 of that Act provide opportunities for the Commission to review rules, including price regulations, and remove them as necessary.

The rules under review in the current NPRM were written more than 10 years ago by the Commission.[31] Since then, by many measures the American telecommunications market has become more not less competitive: expansion of wireless services; the expansion of broadband services; the associate decline in switched access minutes; increased market share of CLECs for many segments of the wireline industry; and even the granting of Section 271 applications by RBOCs.

Given the repeated findings of the Commission over the past decade that the telecommunications industry is becoming more competitive over time, one might reasonably expect a contraction in regulation, particularly price regulation of exchange access services. Yet the NPRM proposes the opposite: an expansion of price regulation of exchange access services to address access stimulation.

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[31] For example, *see* FCC, *Reform of Access Charges Imposed by Competitive Local Exchange Carriers*, Seventh Report and Order and Further Notice of Proposed Rulemaking, Docket 96-262, released April 27, 2001.

VIII. The NPRM fails to recommend deregulation when deregulation is the both the obvious and lawful solution

As I discussed in regarding the NPRM for 07-135, the current NPRM fails to consider the imperative of deregulation.[32] The preamble to the Telecommunications Act state states that it is a law "to promote competition and reduce regulation," not a law to increase regulation.[33] The Act has many sections which focus on deregulation.[34] In rationalizing the proposed new rules with respect to access stimulation, the NPRM does not cite any deregulatory language of the Act.

Had the Commission considered deregulation in the preparation of the NPRM, it likely would have stumbled across the obvious solution. The solution to any market problem with respect to "access stimulation" described in the NPRM is so obvious that is surprising the NPRM does not even address it: clarify that the Communications Act and existing Commission rules allow carriers to pass access charges directly to users. Neither Section 254(g) nor Commission rules prohibit such charges.

> Within 6 months after the date of enactment of the Telecommunications Act of 1996, the Commission shall adopt rules to require that the rates charged by providers of interexchange telecommunications services to subscribers in rural and high cost areas shall be no higher than the rates charged by each such provider to its subscribers in urban areas. Such rules shall also require that a provider of interstate interexchange telecommunications services shall provide such services to its subscribers in each State at rates no higher than the rates charged to its subscribers in any other State.[35]

Notice that Section 254(g) does not prohibit passing along access charges to customers.[36] Indeed, to the extent interstate terminating access charges are the same when calls are originated in any

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[32] See fn 1 *supra*, at Section V.
[33] Preamble to the Telecommunications Act of 1996.
[34] *See*, e.g., Sections 10 and 11.
[35] 254(g).
[36] FCC about geographic rate averaging is in the order creating 47 C.F.R. § 64.1801, not in the rule itself. *See* FCC 96-331, *Report and Order*, August 7, 1996.

state—as they are, passing those charges directly to consumers is consistent with 254(g). The rule implementing 254(g), 47 C.F.R. § 64.1801, has much the same language:

§ 64.1801 Geographic rate averaging and rate integration.
(a) The rates charged by providers of interexchange telecommunications services to subscribers in rural and high-cost areas shall be no higher than the rates charged by each such provider to its subscribers in urban areas.
(b) A provider of interstate interexchange telecommunications services shall provide such services to its subscribers in each U.S. state at rates no higher than the rates charged to its subscribers in any other state.[37]

Without writing a new rule, the Commission could clarify that Section 254(g) and Commission rule 47 C.F.R. § 64.1801 can properly be interpreted to allow access charges to be passed along to consumers. The result would be little different from today when long-distance customers properly are assessed a variety of state and local fees ranging from universal service fees, to 911 charges, to various taxes.

Throughout the NPRM, the Commission discusses changing existing rules, most of which have been in effect for 10 years or more. The Commission's discussion would be enhanced by a presentation of past Commission findings with respect to each existing rule under the mandatory biennial Section 11 review of all rules.[38] The Commission does not refer to any Section 11 review in the NPRM. The Commission should explain to the public how to reconcile its views in 2011 that certain rules need to be substantially modified with its repeated inability under Section 11 in prior years to make similar findings with respect to the same rules.

[37] 47 C.F.R. § 64.1801.
[38] 47 U.S.C. 161.

IX. The NPRM fails to comply with the Regulatory Flexibility Act

In addition, the Initial Regulatory Flexibility Analysis (IRFA) for the NPRM is entirely deficient. The single IRFA is for all proposed rules in the NPRM, and the NPRM provides no separate IRFA for the proposed rule for revenue sharing and access charges. The single IRFA provided fails to meet practically all of the guidelines set forth by the Small Business Administration.[39] For example, with respect to changing the regulation of access charges, the IRFA does not review alternatives, including the obvious alternative of clarifying that carriers may pass along charges to customers. Indeed, the IRFA does not directly address access charge regulation, or any other specific proposed rule change. Instead, it discusses vague and ambiguous language that encompasses the entire proceeding, rather than any single proposed rule change.

Respectfully submitted,

/s/

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[39] Small Business Administration, "A Guide for Government Agencies: How to Comply with the Regulatory Flexibility Act," June 2010, at http://archive.sba.gov/advo/laws/rfaguide.pdf.